IN BRIEF

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Transferring GST Tax Room to the Provinces – A Solution to the Fiscal Imbalance?

INTRODUCTION

The issue of the fiscal imbalance is currently a central element in federal-provincial relations. Many observers and almost all major political parties in Canada now recognize that a fiscal imbalance exists. There is no consensus, however, on its size. Few have tried to quantify it. The Commission québécoise sur le déséquilibre fiscal ventured to do so and evaluated it at nearly $8 billion for all provinces. That was in 2002 and, since then, new federal health transfers and improvements in the equalization program have been announced – in short, the economic situation has changed. Nonetheless, except for Alberta, all the provinces still find it financially difficult to fulfil their responsibilities.

There are two basic ways of solving the problem of the fiscal imbalance: either the federal government can give up tax room, by lowering its taxes in consultation with the provinces; or the federal government can increase its transfer payments.

In January 2006, the election of a new federal government with an economic program based on lowering the Goods and Services Tax (GST) revived the idea that a solution to the fiscal imbalance could be found in transferring to the provinces all or part of the tax room made available by a lower GST rate. This solution and its variations were debated not only by the Commission québécoise sur le déséquilibre fiscal, but also by the Canadian Council of Chief Executives,(1) the Conseil du patronat du Québec(2) and various economists and experts in financial(3) and university(4) circles.

On the basis of data from the latest provincial economic accounts (2003), this publication describes and puts into context the amounts that the provinces could collect if they occupied all or part of the GST field. First, it examines the arguments in favour of using this tax base to offset the fiscal imbalance; then it discusses the difficulties to be resolved before the idea could be implemented.

TRANSFERRING TAX ROOM

- ***What is involved?***

Also called "transfer of tax points," tax room is transferred when a government, in this case the Government of Canada, reduces the amount of tax it imposes, thereby allowing the provinces and territories to increase their taxes by a corresponding amount. The transfer of tax room has no net financial impact on the taxpayer. The only discernible effect is that the provincial and territorial governments receive revenues that the federal government could have collected.

For the provinces and territories, the value of the tax room changes along with the growth rate of the economy, and specifically the revenue potential of the tax base. In the 1990s, there was enormous variation in federal transfer payments to the provinces. Transferring tax room would give the provinces funding that would be shielded from the budget imperatives of the federal government. From this perspective, it would be more predictable. Predictable funding would be one of the provinces' main demands in the recent negotiations on a new framework for the equalization program.

Tax room may be transferred to the provinces in a number of different ways. It may involve all or part of personal income tax, the GST or corporate income tax.

- ***Transferring tax room from the personal income tax field***

Some observers say that for the provinces the best tax base to be transferred is the personal income tax field, because its progressive tax rates have the greatest potential for growth. On the other hand, if the tax base is shared(5) between the federal and provincial governments, a change in the tax structure of one will affect the others. Transferring this tax base is also much more likely to lead to fiscal competition between governments.

- ***Transferring tax room from the GST field***

Most experts believe that transferring tax room from the GST to the provinces is the preferred option in finding a solution to the fiscal imbalance. This approach has a number of significant advantages. It would provide the provinces with guaranteed access to a stable and growing source of income. If the entire GST field were transferred to the provinces to fund growing social spending, the transfer would make it possible to align all provinces' income sources with their actual and constitutional responsibilities.(6) This approach would make the link between taxation and service delivery more transparent.

- ***Transferring tax room from the corporate income tax field***

Another option might be to transfer tax room from the corporate income tax field. Corporate profits can be extremely erratic during a single business cycle, however; consequently, such a transfer would not be advisable for ensuring stable funding for health and social programs. As noted above, predictable tax revenue is a fundamental demand of the provinces.

TRANSFERRING PART OF THE GST FIELD

Lowering the GST rate is a measure that is very popular with consumers. Accordingly, provincial governments are hesitant to move into this tax room and increase their own sales tax to generate new revenue that would resolve, at least partially, the fiscal imbalance. It is interesting, nevertheless, to calculate what transferring this tax field could mean in terms of new revenue for the provinces.

In 2003, revenue from the GST was equivalent on average to 13.1% of all provincial revenues. Table 1 (at the end of this document) shows that GST revenues were higher in the "have" provinces. This fact is particularly obvious when considered on the basis of potential tax revenue per capita. For instance, if 1% of the GST field were transferred to the provinces, Ontario would recover $30 more per capita than Manitoba.

This finding highlights the economic disparities and the tax potential differential between the provinces. Accordingly, the devolution of tax room to the provinces might need to be accompanied by an equalization mechanism so as to avoid aggravating the horizontal fiscal imbalance.

FINDINGS

While it offers some advantages, a new division of the tax base that focusses on consumption taxes entails some challenges. First, unless the equalization program includes compensation mechanisms, transferring the tax base would widen the gap between "have" and "have-not" provinces. In addition, by transferring all or part of the GST – its most stable source of revenue – the federal government would risk more volatility in its own revenues.

Lastly, there is the unique situation of Alberta, which has no provincial sales tax. Considering its financial situation, it is hard to believe this province would want to establish a sales tax to take up the tax field vacated by the federal government.

AUSTRALIAN SOLUTION

Since 2000, in Australia, the revenue generated by the federal Goods and Services Tax represents the value of equalization to be divided among the States. The GST revenue pool is distributed among all States on the basis of recommendations by the Commonwealth Grants Commission (CGC). The CGC's recommendations are

based on principles of horizontal fiscal equalization, which it describes as follows: "each State should be given the capacity to provide the average standard of State-type public services, assuming that it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources." (7)

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(1) Canadian Council of Chief Executives, *From Bronze to Gold: A Blueprint for Canadian Leadership in a Transforming World*, 21 February 2006.

(2) Evidence to the Subcommittee on Fiscal Imbalance of the House of Commons Standing Committee on Finance, 11 April 2005.

(3) Clément Gignac (Chief Economist, National Bank of Canada), "15 questions sur la dette du Québec : La dette avant les impôts," *Journal Les Affaires*, 25 March 2006.

(4) Luc Godbout (Director, Taxation and Public Finance Research Chair, Université de Sherbrooke), "15 questions sur la dette du Québec : La comptabilité d'abord, puis une réserve," *Journal Les Affaires*, 25 March 2006.

(5) It is difficult to believe that the federal government or the provinces would give up the entire personal income tax field to the benefit of the other level of government, considering the amounts at stake.

(6) Some observers feel that transferring the entire GST field to the provinces would also involve abolishing the federal health and social transfers. The amount of the federal revenue generated by the GST is roughly equivalent to the amount of federal health and social transfer payments to the provinces.

(7) See Philippe Le Goff, Australia's Equalization System, PRB 04-60E, Parliamentary Information and Research Service, Library of Parliament, Ottawa, March 2005.

Table 1
Federal Tax Revenue From the GST
by Province, 2003

	Federal Revenue From the GST		Potential Revenue From Provincial Occupation of Tax Room Made Available by a 1% Decrease in the GST	
	Total ($ million)	% of total provincial revenue	Total ($ million)	Additional tax revenue per capita ($)
Newfoundland and Labrador	420	10.6	60	116
Prince Edward Island	120	11.1	17	124
Nova Scotia	820	12.2	117	125
New Brunswick	625	10.5	89	119
Quebec	6,844	11.7	978	131
Ontario	12,774	17.1	1,825	149
Manitoba	968	11.0	138	119
Saskatchewan	866	17.2	124	125
Alberta	3,710	13.5	530	168
British Columbia	4,354	15.7	622	150
Total/Average	31,501	13.1	4,500	133

Source: Provincial economic accounts, 2003 estimates; and author's calculations.